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Michigan's Precarious Budget Situation

Economic Performance

For the eight years ending 2000 the Michigan economy grew at a steady pace. Basic indicators of the state's economic health—personal income, total employment, and the unemployment rate improved throughout the period. During most of that period the state's unemployment rate was below the national rate and Michigan's 2000 average rate was proclaimed as the lowest in the state's history (3.4 percent).

Midway through 2000, indications of a weakening of economic performance began to surface. By early in 2001, it was clear that a downturn was underway. As *Chart 1* shows, FY2001 will be one of only four years in the last three decades in which General Fund-General Purpose (GF-GP) plus School Aid Fund (SAF) revenue had negative growth rates.

Despite the considerable diversification occurring in the State's economy in the past two decades, Michigan is still heavily dependent on the motor vehicle industry. The steadying influence the diversification has had on the State's business cycle has not been sufficient to completely smooth out the effects of large changes in motor vehicle production. Late in 2000, motor vehicle sales began to soften and, after some lag in time, vehicle production began to decline. By January 2001, the year-to-year reductions in production were in the range of 20 percent both nationally and in Michigan. Other statistics mirrored this situation. Motor vehicle equipment employment, average weekly hours worked, and average weekly earnings began deteriorating by mid-2000 and year-to-year declines in all three measures exceeded five percent in the first quarter of 2001. *Table 1* includes selective measures of Michigan's economic performance during the State's current fiscal year (beginning October, 2000). Observations supported by the data include:

Table 1
Selected Economic Indicators
(Changes – FY2001 to date vs FY2000)

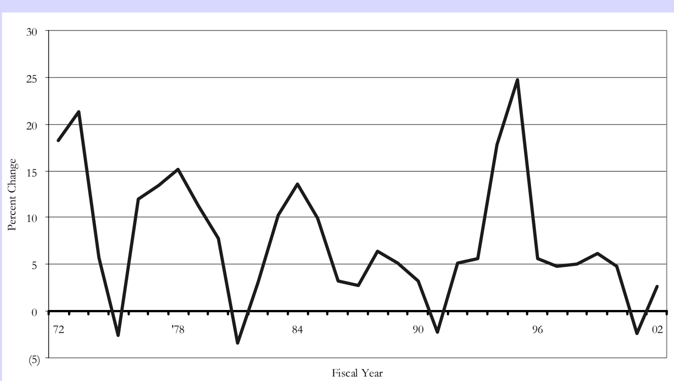
Michigan Total Employment	0.3%
Michigan Labor Force	1.1%
Michigan Number Unemployed	25,300
Michigan Manufacturing Employment	
Except Motor Vehicles and Equipment	(0.2)%
U.S. Light Vehicle Sales	(5.6)%
Michigan Motor Vehicle Production	(20.9)%
Michigan Motor Vehicle & Equipment:	
Average Weekly Hours	(7.4)%
Average Weekly Earnings	(2.7)%
Employment	(5.6)%
Michigan Wholesale Trade- Durable Goods:	
Average Weekly Hours	(8.3)%
Average Weekly Earnings	(8.2)%

Source: Bureau of Labor Statistics, U.S. Department of Labor, CRC calculations.

- The declines in economic activity are relatively concentrated in motor vehicles and equipment and directly attributable to declines in production.
- Manufacturing employment in areas other then motor vehicles and equipment are basically unchanged during this fiscal year.

Further, job growth in non-manufacturing was not sufficient to absorb new entrants into the labor force since the end of the calendar year. As a consequence, unemployment has jumped up to 4.7 percent in April compared with 3.4 percent a year ago.

Chart 1
Percent Changes in General Fund-General Purpose plus School Aid Fund Revenues



Source: Senate Fiscal Agency.

State Budget Problems

The economic deterioration has been paralleled by weak tax revenue collections. When the FY2001 state budget was passed by the legislature, GF-GP and SAF revenues were

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forecasted to increase by 3.1 percent compared with FY2000 revenues. Revenue forecasts have been reduced twice since the original forecasts made in May 2000; first in January 2001 and again in May 2001, *Table 2* summarizes the revenue revisions for major tax sources.

The latest revisions translate to significant holes in the State budget. Of greatest interest to Lansing policy makers are the effects on the GF-GP and SAF budgets. For FY2001 the two funds are now projected to fall $604 million and $349 million short of the *original* estimates (May 2000 Consensus) upon which the adopted budget was based. For FY2002, the corresponding differences from the revenues forecasts upon which the Governor's proposed budget is based are $519 million and $224 million respectively.

The options to close these gaps are very different in FY2001 and in the next two fiscal years:

FY2001—Several one-time adjustments totaling $602 million will likely be employed. They include using the $212 million General Fund surplus from FY2000, converting three large capital projects from pay-as-you-go to bonding ($212 million), a withdrawal from the State's $1.3 billion rainy day fund ($71 million), a hiring freeze ($24 million), and other savings totaling $83 million. SAF revenue shortfalls can be accommodated by using a portion of the FY2000 SAF surplus of $853 million, thereby avoiding any cuts in spending.

FY2002—The consensus estimated $571 million GF-GP shortfall in FY2002 will be more difficult to close than the FY2001 gap. Possible approaches include cutting GF-GP supported programs, a further withdrawal of rainy day fund resources, reductions in revenue sharing for local units of government, postponing scheduled rate reductions in the personal income and single business taxes, and continuing limits on hiring employees. The SAF gap of $175 million after the fund surplus remaining at FY2001 yearend is used cannot be closed without more SAF resources (possibly from the rainy day fund) or reductions in spending for local schools. Heavy reliance on the rainy day fund could deplete the fund causing problems with the State's credit rating and difficulties in cash management.

FY2003—FY2003 has a number of built-in problems for both the General and School Aid Funds. The enacted school aid budget includes an increase of $215 million in the grant from the General Fund. Even with this increase, the SAF revenues are about $390 million short of the appropriated expenditures. The General Fund faces, in addition to the grant to the SAF, scheduled rate reductions in the personal income and single business taxes, the potential effects of Federal tax cuts, including reductions in state tax revenues associated with federal inheritance tax changes. In addition, with the FY2002 revenues reduced from earlier forecasts, growth in FY2003 will likely yield less total revenue than would have occurred had the FY2002 base not been reduced.

It may be appropriate to incorporate all three fiscal years in devising solutions to this significant budget problem.

Table 2
Selected Major Taxes
Changes in Consensus Forecasts for FY2001

	Consensus Growth Rates			YTD Collections
Tax	May 2000	January 2001	May 2001	(Oct.-March) Growth Rates
Personal Income Tax (before refunds)	5.8%	2.7%	(1.0)%	(4.0)%
Sales Tax	5.2%	3.3%	2.1%	2.3%
Use Tax	4.7%	4.6%	(0.2)%	(3.8)%
Single Business Tax	3.4%	3.6%	(2.4)%	(7.3)%
Total GF-GP and School Aid Fund Revenues	3.1%	0.7%	(2.4)%	(2.4)%